

# THE UNIVERSITY OF TEXAS SCHOOL OF LAW

Law and Economics Working Paper No. 002  
October 2003



The Rise of State Bankruptcy-Directed Legislation

*Ronald J. Mann*

The University of Texas School of Law

This paper can be downloaded without charge from the  
Social Science Research Network Electronic Paper Collection:  
<http://ssrn.com/abstract=508442>

An index to the working papers in  
The University of Texas School of Law Working Paper Series  
is located at: <http://www.utexas.edu/law/>

# THE RISE OF STATE BANKRUPTCY-DIRECTED LEGISLATION

Ronald J. Mann\*

## TABLE OF CONTENTS

I. Introduction.....	1
II. The Old System.....	2
III. The Rise of Bankruptcy-Directed Legislation .....	7
A. Security Interests in Intangibles.....	7
B. Proceeds .....	9
C. Pro-Securitization Statutes.....	10
IV. Responding to the Problem.....	12
V. Conclusion .....	20

---

\* William Stamps Farish Professor in Law, University of Texas School of Law. I thank Allison Mann for unceasing aid of all kinds and Bill Powers for unstinting support. This paper was prepared for a presentation at an April 2003 conference on “Threats to Secured Lending” at the Cardozo School of Law of Yeshiva University. I thank the participants at that conference for thoughtful comments on my presentation at that conference. For comments on earlier drafts, I thank Jonathan Lipson, Jay Westbrook, and Ernie Young.



# THE RISE OF STATE BANKRUPTCY-DIRECTED LEGISLATION

Ronald J. Mann

## I. INTRODUCTION

The papers at this conference generally focus on the rise of securitization and the possibility that statutes designed to remedy abuses of securitization will wreak undue havoc on our capital markets. I take my starting point from the relatively intractable policy questions that those problems raise. It seems to be a given that securitization provides financing at lower cost to the large companies that use those transactions.<sup>1</sup> If so, rules fostering securitization could enhance the overall performance of our economy. At the same time, there are legitimate concerns that the rise of securitization makes it less likely that large companies in financial distress will have unencumbered assets on their balance sheets to satisfy any substantial portion of the claims of unsecured creditors.<sup>2</sup> The balance between those concerns raises questions that are as difficult to resolve here as they are in the context of conventional secured credit, in which they have been a frequent topic for decades.<sup>3</sup>

What has brought those concerns to the forefront – and what motivates me to write – is that States have been led by those concerns to take the lead in attempting to decide how those issues will be resolved in bankruptcy proceedings. Accordingly, in this paper I step back from that debate to ask a more fundamental question: who is to decide the appropriate policy response to those issues? On the one hand, Congress could decide those questions in the exercise of its exclusive constitutional power to enact bankruptcy laws.<sup>4</sup> Or, if it chose to do so, in the exercise of its authority over interstate commerce.<sup>5</sup> Conversely, the states could resolve those questions in the exercise of their traditional control over basic issues of commercial law, reflected most prominently in the Uniform Commercial Code. Securitization raises difficult policy questions in part because it falls at the boundary between those two spheres: the effect and legitimacy of those transactions is plainly an important question of commercial law, but much of what is most important involves specific questions about how the transactions are treated in bankruptcy.

This paper is distinct from the body of existing literature on the topic because I am focusing not on the commercial-law questions common to discussions of the topic – Are the securitization transactions efficient? Do they inappropriately undermine the stability of originators? – but instead on federalism

---

<sup>1</sup> See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U.L.Q. 1061, 1085-1106 (1996) (discussing the advantages of securitization).

<sup>2</sup> See Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 23-30 (1996) (discussing those concerns).

<sup>3</sup> For summaries of the literature, see Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 628-29 (1997) [hereinafter Mann, *Explaining the Pattern*]; Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1073-83 (1989).

<sup>4</sup> U.S. Const. art. I, § 8, cl. 4.

<sup>5</sup> U.S. Const. art. I, § 8, cl. 3.

questions: as a matter of allocation of power, when does the supervening power of federal law<sup>6</sup> preempt state efforts to address those questions?<sup>7</sup>

My analysis proceeds in three steps. First, I describe the basic system that successfully delineated responsibility between Congress and the state legislatures until recent years (perhaps about 1990), and a number of systemic factors that have caused the old system to break down. Second, I discuss examples of potentially problematic legislation – not only legislation related to securitization, but other pieces of state legislation that have their primary effects in the bankruptcy of the affected parties. Finally, I use those examples to illustrate when those statutes should – and should not – be held preempted by Congress’s authority under the Bankruptcy Code.

## II. THE OLD SYSTEM

The legal system that governs financing transactions traditionally has been divided into two separate tiers. The Bankruptcy Clause grants Congress authority to enact uniform laws about Bankruptcy, a power that excludes parallel state legislation.<sup>8</sup> That power – dormant through much of the 19<sup>th</sup> century<sup>9</sup> – has been exercised continuously, and with increasing complexity, since enactment of the Bankruptcy Act of 1898.<sup>10</sup> That power at its core defines the resolution of issues that arise when businesses and individuals fail.<sup>11</sup>

---

<sup>6</sup> See U.S. Const. art. VI, cl. 2.

<sup>7</sup> I am far from the first to see the federalism issues in bankruptcy. See, e.g., Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure* (unpublished manuscript on file with author) (arguing that bankruptcy law should be understood as a federal procedural remedy for business distress); Thomas E. Plank, *Bankruptcy and Federalism*, 71 *FORDHAM L. REV.* 1063 (2002) (framework for when Congress must follow state law and when it is permissible to overrule state law). Neither of those papers focuses on the federalism question at the core of the securitization debate. All accept (I think) that Congress *could* reject at least the bankruptcy effects of the statutes I discuss in this paper. The question of interest here is whether they are preempted by the existing statute – in a sense, the question is whether the Bankruptcy Code as it now exists preempts those statutes. It is clear, by the way, that the Bankruptcy Clause itself has no dormant preemption effect. E.g., *Butner v. United States*, 440 U.S. 48, 54 n.9 (1979) (“[S]tate laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress.”); *Stellwagen v. Clum*, 245 U.S. 605, 613 (1918) (same).

<sup>8</sup> The breadth of that power was an important topic in the 19<sup>th</sup> century when Congress had not enacted a permanent bankruptcy law. Compare *Sturges v. Crowninshield*, 17 U.S. 122 (1819) (invalidating state statute that discharged debt created by contract entered into *before* statute), with *Ogden v. Saunders*, 25 U.S. 213 (1827) (validating state statute that discharged debt created by contract entered into *after* statute).

<sup>9</sup> See, e.g., Charles J. Tabb, *The History of Bankruptcy Laws in the United States*, 3 *AM. BANKR. INST. L.J.* 5, 13-14 (1995) (discussing early history of American bankruptcy law).

<sup>10</sup> See DAVID A. SKEEL, *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001) (discussion of 20<sup>th</sup> century American bankruptcy law).

<sup>11</sup> Chuck Mooney offers a revisionist view in which the basic function of bankruptcy law is procedural – providing a unified (and thus necessarily federal) forum for the resolution of issues of general financial distress. See Mooney, *supra* note 7 (9-1-03 draft subpart III(D)).

And even in the bankruptcy context, Congress traditionally has refrained from enacting basic rules about commercial transactions and the property rights that they create. For example, in *Butner v. United States*,<sup>12</sup> the Court considered whether a mortgage extends to rents collected from the collateral after the date of bankruptcy but before the date of a post-bankruptcy foreclosure sale. The Court rejected a lower-court rule that had articulated a federal-common-law rule resolving that question. Rather, the Court held, the scope of the security interest was to be resolved in accordance with the laws of the State in which the collateral was located. The Court explained:

Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy.<sup>13</sup>

Similarly, in *BFP v. Resolution Trust Corporation*,<sup>14</sup> the Court held – despite language in Section 548 that plainly would have supported a contrary result<sup>15</sup> – that the federal bankruptcy system will not overturn the results of a conventional real-property foreclosure that is properly conducted under state law.<sup>16</sup> Thus, Congress generally has left it to the states to provide basic rules that define property rights and establish ground rules for the bulk of commercial transactions.

The Court's use of a strong interpretive principle to narrow the substantive reach of the Bankruptcy Code is not unique to *BFP*. For example, in *Kelly v. Robinson*,<sup>17</sup> the Court held that a discharge in bankruptcy did not extend to restitution obligations imposed as part of a criminal sentence, despite language strongly supporting a contrary result.<sup>18</sup> Central to those cases is a conscious reliance on principles of federalism to justify a narrow interpretation of the statutory language. For example, the first substantive part of the opinion in *Kelly* discusses not the statutory language, but the importance of taking account of nontextual policies, prominently including the policy of federal respect for state criminal proceedings

---

<sup>12</sup> 440 U.S. 48 (1979).

<sup>13</sup> 440 U.S. at 54-55.

<sup>14</sup> 511 U.S. 531 (1994).

<sup>15</sup> Essentially, the Court holds that the price at which an asset is sold is not relevant to the question of whether the asset was sold for “less than a reasonably equivalent value” under Bankruptcy Code § 548(a)(1)(B)(i). See 511 U.S. at 549-59 (Souter, J., dissenting).

<sup>16</sup> 548 U.S. at 536-46 (per Scalia, J.). In fairness, I should mention that I argued the *BFP* case on behalf of the Resolution Trust Corporation.

<sup>17</sup> 479 U.S. 36 (1986).

<sup>18</sup> See Robert K. Rasmussen, *A Study of the Costs and Benefits of Textualism: The Supreme Court's Bankruptcy Cases*, 71 WASH. U. L.Q. 535, 560-63 (1993) (discussing the nontextual approach in *Kelly*).

reflected in *Younger v. Harris*.<sup>19</sup> Similarly, Justice Scalia's opinion in *BFP* places considerable weight on the Court's sense of the importance of the relevant state interests:

Federal statutes impinging upon important state interests "cannot ... be construed without regard to the implications of our dual system of government.... [W]hen the Federal Government takes over ... local radiations in the vast network of our national economic enterprise and thereby radically readjusts the balance of state and national authority, those charged with the duty of legislating [must be] reasonably explicit."<sup>20</sup>

In addition to the authority granted by the Bankruptcy Clause, the Commerce Clause doubtless grants Congress broad authority to regulate all aspects of commerce.<sup>21</sup> Even in a post-New Deal world rife with Congressional use of that authority, Congress traditionally has left it to the states to enact legislation articulating the ground rules for commercial transactions.<sup>22</sup> From a historical perspective that is not too surprising. From the days of Lord Mansfield, the rules of commercial law traditionally have been rules of common law.<sup>23</sup> Until the late 19<sup>th</sup> century, it never would have occurred to anybody that it was a sensible endeavor to codify those rules.<sup>24</sup> And thus, during the period of *Swift v. Tyson*,<sup>25</sup> those rules fell within the broad sweep of the American common-law system – the identity of the ultimate source of the rules of decision was as ambiguous at that time for commercial law as it was for any other topic of common law.<sup>26</sup>

What is surprising is the success of the American Law Institute and the National Conference of Commissioners on Uniform State Laws in achieving uniform enactment of the Uniform Commercial Code. That process has created an unusual situation – state laws that function as a single American commercial law, substantially as uniform as a federal statutory enactment. That early success may have something to do with Congress's willingness to refrain for some time from preempting any significant portion of the field. But it remains to be seen whether that enterprise ultimately will turn out to be only a short post-*Erie* interlude.<sup>27</sup> The growing difficulties that NCCUSL has had in drafting and obtaining adoption of balanced

---

<sup>19</sup> See *Kelly*, 479 U.S. at 47-48. {I clerked for Justice Powell the term that the Court decided *Kelly*. It should go without saying that my comments on that case do not reflect his views.}

<sup>20</sup> 511 U.S. at 544 (quoting Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 539-40 (1947)) (ellipses and brackets by *BFP* Court). The *Kelly* opinion quotes the same passage. 479 U.S. at 49 n.11.

<sup>21</sup> *United States v. Lopez*, 514 U.S. 549, 561 (1995) (invalidating gun-free school zone statute because "has nothing to do with 'commerce' or any sort of economic enterprise, however broadly one might define those terms").

<sup>22</sup> See generally G. Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, 74 AM. BANKR. L.J. 227, 239-41 (2000) (discussing the "federalist" nature of bankruptcy law).

<sup>23</sup> See Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 447-52 (1979) (discussing the role of Judge Mansfield).

<sup>24</sup> See Gilmore, *supra* note 23, at 456-60 (discussing the Negotiable Instruments Law, the first major codification of American commercial law).

<sup>25</sup> 41 U.S. (16 Pet.) 1 (1842).

<sup>26</sup> See Mooney, *supra* note 7, at 89-102 (discussing the incoherence of *Swift* as it applied to commercial law).

<sup>27</sup> See Robert K. Rasmussen, *The Uneasy Case Against the Uniform Commercial Code*, 62 LA. L. REV. 1097 (2002) (discussing problems with the UCC process); Robert E. Scott, *The Rise and Fall of Article 2*, 62 LA. L. REV. 1009 (2002) (same).

legislation – the debacle of UCITA being the most obvious example<sup>28</sup> – have made it more common for Congress to step in to the most traditional areas of commercial law. The passage of E-SIGN in 2000<sup>29</sup> and the imminent passage of the Check 21 Act<sup>30</sup> are signal examples.

From the vantage point of the 21<sup>st</sup> century, the weakest point of that two-tiered “system” of allocating rulemaking authority is the boundary between the two tiers: whenever parties that have engaged in commercial transactions file for bankruptcy, the rules for those transactions will affect the outcome in the bankruptcy proceeding. The problem that boundary presents is how to constrain the States from “cheating” by writing rules that formally operate as ordinary rules of commercial law but in fact are directed<sup>31</sup> at situations of business failure – State promulgated bankruptcy-directed legislation.<sup>32</sup>

The Bankruptcy Code itself includes a pair of formal limits on state cheating – statutory provisions that invalidate state legislation if it too brazenly attempts to influence bankruptcy outcomes. The first of those deals with the Bankruptcy Code’s recognition of the security interest that has been elevated to prominence under Article 9 of the Uniform Commercial Code. States might attempt to cheat by characterizing novel interests as security interests solely for the purpose of ensuring a good recovery in bankruptcy, even if the claim would not have a substantial priority against conventional competing creditors. Section 544(a) responds to that concern by allowing the trustee in bankruptcy to invalidate any claim that a lien creditor could defeat outside of bankruptcy.<sup>33</sup> Thus, unless the state is willing to allow the

---

<sup>28</sup> Originally intended to be a new article of the UCC, UCITA first was downgraded to a uniform law (for which consent of the American Law Institute was not necessary). Finally, in August of 2003 even NCCUSL dropped its support of the failed effort. Alorie Gilbert, *Supporters Back away from Software Bill* (Aug. 8, 2003), available at <http://www.businessweek.com/technology/cnet/stories/5061061.htm>.

<sup>29</sup> Electronic Signatures in Global and National Commerce Act, Pub. L. No. 106-229 (2000), codified at 15 U.S.C. § 7001 et seq.

<sup>30</sup> The House on June 5 passed the Check 21 Act, H.R. 1474. The Senate on June 26 passed its version, the Check Truncation Act, S. 1334. The statute generally is designed to facilitate the processing of checks by means of images instead of the cumbersome paper originals. For explanation from the Federal Reserve (which drafted the statute), visit <http://www.federalreserve.gov/paymentsystems/truncation/default.htm>. The same topic was within the mandate of the Drafting Committee recently charged with promulgating revisions to UCC Articles 3 and 4 (of which I was the Reporter). The Committee was unable to pursue that topic because of its inability to produce a consensus regarding an appropriate reconciliation of the interest in technological advance with the concerns of consumers about continuing to receive their cancelled checks. The Federal Reserve, of course, is free to proceed at the federal level without such a consensus.

<sup>31</sup> The most difficult question in drawing the line between permissible and impermissible state legislation probably is the question whether the key feature is the “intent” of the legislation or its “effect.” As I discuss in Part IV, my thesis turns on effect, not intent. Specifically, I argue that statutes are impermissibly “directed” at bankruptcy if they have no substantial effect outside of bankruptcy.

<sup>32</sup> Marcus Cole explains that the potential for interjurisdictional competition is both the good and the bad side of the federalist aspect of bankruptcy law: by leaving substantial policymaking authority to the states, Congress has left open the possibility of the same kind of “race to the bottom” that some scholars have discerned in American corporate law. *See Cole, supra* note 22, at 238-39.

<sup>33</sup> Bankruptcy Code § 544(a)(1).

interest sufficient vigor in pre-bankruptcy priority disputes, the Bankruptcy Code will not respect the interest in bankruptcy proceedings.

The second of the Bankruptcy Code protections deals with a timing problem. States might create an interest of undoubted vigor – which would defeat lien creditors and thus survive Section 544(a) – but limit the costs the interest would impose on conventional creditors by deferring the effectiveness of the interest until bankruptcy proceedings. The Bankruptcy Code invalidates those interests in Section 545 by providing that the Bankruptcy Code will not recognize any lien that is not “effective” before the commencement of the bankruptcy proceeding.<sup>34</sup>

Those statutes standing alone prevent certain types of blatant intervention in the bankruptcy process. The question this paper addresses is whether the Bankruptcy Code preempts other less-blatant interventions. As recent history (discussed below) illustrates, the specific provisions in the Bankruptcy Code do not exhaust the potential devices that states might use to interfere in the bankruptcy process. It may be that practical circumstances limited the strain placed on those provisions for a considerable time after their enactment. Most obviously, business bankruptcy was relatively uncommon until the enactment of the Bankruptcy Code in 1978.<sup>35</sup> Because business bankruptcy was relatively uncommon, there was a relatively small incentive for creditors to invest resources in the development and enactment of legislation in the area. That is not to say, of course, that business failures were rare before 1978, or that lenders were not interested in the terms of the Bankruptcy Code of 1978. It is true, however, that federal bankruptcy law is under more intense scrutiny now than it was a quarter-century ago.

Related to that point is the obvious shift in the way in which commercial law is made. When I was in school, I heard stories about the drafting of the Uniform Commercial Code by small groups of scholars of daunting intellect in sultry Chicago summers without air-conditioning.<sup>36</sup> That era – when commercial law was something “technical” to be resolved by “experts” – has faded almost from memory. Business bankruptcies are now an everyday affair – even for the largest firms in the economy – sufficiently so that “bankruptcy planning” is a central part of most major business transactions.<sup>37</sup> Similarly, specially designed “bankruptcy remote” entities are now commonplace.<sup>38</sup> It is not an exaggeration to say that every significant commercial financing transaction is significantly shaped by an effort to avoid the potential adverse effects of bankruptcy law.

---

<sup>34</sup> Bankruptcy Code § 545(a)(1).

<sup>35</sup> Chapter 11 filings (a major subset of business filings) have risen from 6,348 in 1978 to 11,270 in 2002. 2003 BANKRUPTCY YEARBOOK AND ALMANAC 5. Those filings are significantly underinclusive because of the frequency of so-called “Business 13s,” Chapter 13 filings related to a business. See Elizabeth Warren and Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1264-65 (1994) (making that point).

<sup>36</sup> See Allison Dunham, *Reflections of a Drafter: Allison Dunham*, 43 OHIO ST. L.J. 569, 569 (1982). Of course, there always is the possibility that commercial-law drafting never was more immune from interest-group pressures than it is now, and that “memories” of such a time are as false as many nostalgic memories.

<sup>37</sup> For example, the PLI database on Westlaw shows 82 presentations discussing “bankruptcy planning” or “insolvency planning” since 1986.

<sup>38</sup> 44 PLI programs discussed “bankruptcy remote[ness]” in 2002 alone.

Nor would we expect sophisticated creditors acting in a world familiar with the precepts of public-choice theory to limit their efforts to the design of the transactions in which they extend financing. The process of crafting commercial legislation is now dominated by the influence of the most directly affected interest groups, in most cases the interests of some class of creditors or financial institutions. This is seen quite clearly in recent experiences involving reform of the UCC and bankruptcy laws. For example, although Article 9 successfully emerged from the process and, indeed, has gained uniform enactment with great speed, a dominant aspect of the process was a pitched battle between the interests of secured lenders and consumers, a battle fought directly in terms of the interests of those parties rather than any notion of “sound” commercial principle.<sup>39</sup> Similarly, the most prominent feature of the long-simmering effort at bankruptcy reform has been a major (and successful) push by the credit-card industry to include in the legislation “means-testing” principles that control the choice consumer filers make between Chapters 7 and Chapter 13.<sup>40</sup>

The interstate aspect of most insolvencies exacerbates the problem considerably. The lack of symmetry between the scope of the typical large-business bankruptcy and the jurisdiction of any particular state creates a powerful incentive for self-dealing: the adoption of rules that might favor the in-state interests in any particular bankruptcy, at the expense of out-state interests not well represented in the local legislative process. Thus, it should be no surprise that we now see a considerable amount of legislation that directly tests the boundary between state and federal authority. With that background, the next part turns to the task of describing specific examples of such legislation.

### III. THE RISE OF BANKRUPTCY-DIRECTED LEGISLATION

To get a sense for the problem, this section of the paper considers three recent examples of state legislation that could be characterized as bankruptcy-directed legislation: UCC § 9-408 (regarding security interests in general intangibles), the definition of proceeds in UCC § 9-102(a)(64), and state legislation related to securitization transactions.

#### *A. Security Interests in Intangibles*

My first topic is UCC § 9-408. That section provides that a security interest in a promissory note or a general intangible is valid, even in the face of a term in the relevant document that forbids such an assignment.<sup>41</sup> Consider, for example, a software license that bars the licensee from assigning the software to a third party. In the framework of an Article 9 loan to the software user, that license is a general intangible, the licensor is the account debtor (the party obligated to perform under the license), and the licensee is the debtor.<sup>42</sup> Subsection (a) of Section 9-408 invalidates the prohibition on assignment,

---

<sup>39</sup> See Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569, 614 (1998) (detailing the history of that controversy).

<sup>40</sup> See Jay Lawrence Westbrook, *Empirical Research in Consumer Bankruptcy*, 12 J. BANKR. L. & PRACTICE 3, 10-13 (2003) (discussing the push for those provisions).

<sup>41</sup> The provision also applies to an agreement relating to a health-care-insurance receivable. For clarity of exposition, I omit express discussion of that portion of the provision.

<sup>42</sup> See RONALD J. MANN & JANE KAUFMAN WINN, ELECTRONIC COMMERCE 517-21 (2002).

permitting the licensee to grant a valid security interest without regard to the terms under which the software is licensed.

For present purposes the problem is that subsection 9-408(d) limits the effectiveness of the security interest so that the secured party has no rights of significance under state law: it cannot use the collateral, take possession of it, resell it, or in any other way “enforce the security interest.” The limitations are not at all unreasonable. For example, in the context of the software license hypothetical introduced above, it is arguably the case that federal law would preempt any state law that validated a transfer of the collateral without the consent of the licensor.<sup>43</sup> And the difficulty that a lender faces in transferring software “purchased” by its borrower is central to the increasingly prevalent practice of software financing.<sup>44</sup>

But the fact remains that the response of the UCC drafters to the limitations of supervening federal law was *not* to forbid security interests that would transgress on supervening federal IP-related policy interests. Rather, the response was to permit the security interest as a formal matter, but to strip it so completely of substantive effect as to vitiate any substantial complaint on the part of those concerned about the federal IP rules.<sup>45</sup>

Comment 7 makes clear the reason for this odd resolution of the problem: a specific and conscious intention of ensuring that the rights of the lender would be treated as a secured claim in any bankruptcy proceeding that later might arise.<sup>46</sup> Out of the many choices available to the drafters, that particular choice is the one that raises the concern about which I write – a classic case of bankruptcy-directed legislation.<sup>47</sup>

---

<sup>43</sup> See *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9<sup>th</sup> Cir. 1996); see also *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 242-43 (Bankr. S.D.N.Y. 1997) (applying the *Everex* holding to a nonexclusive license of copyrighted videotapes).

<sup>44</sup> See Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L. REV. 134, 151-53 (1999) (discussing that problem).

<sup>45</sup> The old Article 9 did not directly deal with the question. It invalidated anti-assignment terms only in general intangibles “for money due or to become due,” a category that would exclude software licenses of the type discussed in the text. Old UCC § 9-318(4). Thus, for those licenses, the general rule applied that a lender was subject to all of the terms of the license (including those that prevented the grant of a security interest. Old UCC § 9-318(1).

<sup>46</sup> That comment explains: “This section could have a substantial effect if the assignor [that is, the borrower/licensee] enters bankruptcy.” The comment goes on to include a lengthy example in which the effect of the provision is that the “security interest would attach to the proceeds of any sale of the [business] while a bankruptcy is pending.” UCC § 9-408 comment 7 (Example 4).

<sup>47</sup> Comment 8 contends that “[t]he principal effects of this section will take place outside bankruptcy.” UCC § 9-408 comment 8. It is difficult to assess those arguments in the variety of contexts to which they might apply, but at least as far as software lending is concerned (the area with which I have most familiarity), the only significant effect that the provision mentions is an increase in lending that hypothetically should follow because of the improved outcome in bankruptcy. See *id.* The comment also suggests obscurely that a lender “may ascribe value to the collateral \* \* \* even if this section precludes the secured party from enforcing the security interest,” at least in cases where the agreement of the licensor to the security interest will be forthcoming. In the software context, that agreement is not likely ever to be forthcoming. See Mann, *supra* note 44, at 152. Finally, the comment refers to cases in which the collateral might generate proceeds to which Article 9 might apply. Again, that seems unlikely to be a significant issue when the collateral is the licensee’s interest in a nonexclusive license of software that cannot be

### B. Proceeds

The second UCC provision is the expansion of the definition of proceeds in UCC § 9-102(a)(64). Under the old version of Article 9, proceeds were limited to “whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds.”<sup>48</sup> Thus, to focus on the most important limitation implicit in that phrase, a security interest in proceeds would not cover anything that the borrower received without disposing of the collateral. That limitation resulted in a variety of holdings excluding from the reach of a security interest in proceeds such things as dividends accruing with respect to stock and rent received in return for a lease of the collateral.<sup>49</sup>

Under the revised Article 9, the term “proceeds” is defined much more broadly. The revised statute defines the term to include not only “whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral”<sup>50</sup> – a version of old 9-306(1) broadened to include leases and licenses – but also broader general categories like “whatever is collected on, or distributed on account of, collateral” and “rights arising out of collateral.”<sup>51</sup>

There are of course valid commercial-law motivations for that extension. The analogous provisions of the old version of Article 9 were plagued by frequent litigation that turned on obscure distinctions with no obvious connection to issues of financing policy.<sup>52</sup> If the new Article 9 ends such litigation by sweeping all conceivable interests into the definition of proceeds, that may be a good thing – at least as a matter of state commercial-law policy.<sup>53</sup>

The problem for this paper, however, is that the broadening of the proceeds interest in Article 9 could have important consequences in a bankruptcy proceeding that have little or nothing to do with that policy. The most obvious arises from the use of the term “proceeds” in Bankruptcy Code § 552(b)(1). Section 552(a) creates a general rule that property acquired by a debtor (or its estate) after bankruptcy “is not subject to any lien” resulting from a pre-bankruptcy security agreement. Standing alone, that provision could have important effects on a bankruptcy proceeding by causing the debtor to hold a substantial body of unencumbered assets. The reach of that provision is limited, however, by the exception in Section 552(b)(1) under which a security interest does attach to “proceeds” of collateral received by the debtor while the bankruptcy is pending.

---

transferred or altered by the licensee. The most likely example is information that the borrower might collect through use of the software. See Jonathan C. Lipson, *Remote Control: Revised Article 9 and the Negotiability of Information*, 63 OHIO STATE L.J. 1327, 1374 (2002) (discussing that possibility).

<sup>48</sup> UCC § 9-306(1) (2000).

<sup>49</sup> See Lipson, *supra* note 47, at 1373 (discussing those cases).

<sup>50</sup> UCC § 9-102(a)(64)(A).

<sup>51</sup> UCC § 9-102(a)(64)(B) & (C); see Jonathan C. Lipson, *Financing Information Technologies: Fairness and Function*, 2001 WIS. L. REV. 1068, 1134-39 (discussing the breadth of that phrase).

<sup>52</sup> See Lipson, *supra* note 47, at 1372-78 (examples of conflicting results under the old statute).

<sup>53</sup> See UCC § 9-102 comment 13 (suggesting that broadened definition is designed to “resolv[e] ambiguities” in old § 9-306(1)).

If federal courts interpret the reference to “proceeds” in Section 552(b)(1) as coextensive with the definition of proceeds in the revised Article 9, the expansion of the definition will increase the likelihood that all property the debtor acquires during the bankruptcy will be governed by Section 552(b)(1), and thus that all property will remain encumbered despite the seeming generosity of Section 552(a).<sup>54</sup> It is difficult to assess the practical significance of this change. After all, Section 552(b)(1) extends the creditor’s interest not only to proceeds of collateral, but also to “product, offspring, or profits of such property.” It is possible that many of the assets swept into the new definition of proceeds already would have been covered by Section 552(b)(1) even before Article 9 was revised.<sup>55</sup> But the point for this paper remains the same whether the effect is important or minor: if the expansion of the Article 9 definition was directed specifically at bankruptcy outcomes, that would go at least a step beyond the appropriate bounds of the state lawmaking process.

### C. Pro-Securitization Statutes

The final example is a more obvious one – state statutes designed to foster securitization. As suggested above, the rise of securitization transactions has produced a powerful impetus for legislation ensuring that those transactions receive favorable treatment in bankruptcy. Specifically, the goal is that the assets covered by those transactions will be treated as sold from the originator (typically a large publicly traded company, which ultimately will receive the funds generated by the transaction) to the bankruptcy-remote trust that is the vehicle for the transaction.<sup>56</sup> Thus, if the bankruptcy courts respect the design of the transaction, a bankruptcy of the originator will not affect the securitized assets, because they will not be property of the estate of the bankrupt originator.<sup>57</sup>

The first round of this battle began with the decision of the Tenth Circuit in *Octagon Gas*, holding that financial assets sold by the debtor before its bankruptcy nonetheless would be included in its bankruptcy estate.<sup>58</sup> The Permanent Editorial Board of the Uniform Commercial Code attempted to limit the uncertainty caused by that decision by its 1994 circulation of PEB Commentary No. 14. That commentary amended UCC § 9-102 comment 2 to emphasize that nothing in Article 9 should be interpreted to stand in the way of securitization transactions. Informed observers recognized that this was not a problem to be solved definitively without more specific statutory treatment.<sup>59</sup>

---

<sup>54</sup> Ray Warner has discussed this problem in detail. G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 ABIL REV. 3, 62-66 (2001).

<sup>55</sup> For Ray Warner’s argument that the expansion will have a major practical impact, see Warner, *supra* note 54, at 65-66.

<sup>56</sup> *E.g.*, Steven L. Schwarcz, *Securitization Post-Enron*, [CARDOZO SYMPOSIUM] (3/10/03 draft at 1-2) (discussing those transactions).

<sup>57</sup> *E.g.*, Schwarcz, *supra* note 56 (3/10/03 draft at 4) (discussing the purpose of those transactions).

<sup>58</sup> *Octagon Gas Systems, Inc. v. Rimmer*, 995 F.2d 948, 957 n.9 (10<sup>th</sup> Cir. 1993).

<sup>59</sup> See JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* 748-49 (4th ed. 1995) (criticizing the revision as an *ex post facto* alteration of the statute and expressing a “slightly squeamish” reaction to the use of a PEB commentary to address the problem).

The issue became even more prominent during proceedings in the LTV case in 2002. In that case, the bankruptcy court in the bankruptcy of LTV Steel Company, Inc. permitted the bankrupt originator to use funds collected from previously “sold” assets pending its analysis of the true-sale issue.<sup>60</sup> That incident showed that the efforts to address the problem in the revised Article 9 (the topic of Jim White’s paper at this conference)<sup>61</sup> would not be entirely successful.

That continuing uncertainty about the bankruptcy treatment of what is fast becoming one of the most important financial transactions for large firms in our economy<sup>62</sup> has led to a continuing push for legislative action. For present purposes, the most important effect has been the enactment of the burgeoning statutes that effectively offer “check-the-box” treatment for parties entering securitization transactions. Generally, those statutes permit parties to obtain “true sale” treatment simply by selecting the appropriate label for their transaction. The most prominent example certainly is Delaware’s Asset-Backed Securities Facilitation Act, which provides that any assets purported to be transferred in a “securitization transaction” “shall be deemed to no longer be the property, assets or rights of the transferor.”<sup>63</sup> Similar statutes also appear in Alabama,<sup>64</sup> North Carolina,<sup>65</sup> and Ohio.<sup>66</sup> Texas<sup>67</sup> and Louisiana<sup>68</sup> have adopted non-standard versions of UCC Article 9 that have a similar effect.

---

<sup>60</sup> 2001 Bankr. Lexis 131 (Feb. 5, 2001). For a careful description of that incident, see Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. BANKR. L. & PRACTICE 101, 107-08 (2002).

<sup>61</sup> See James J. White, *Chuck’s (and Steve’s?) Peccadillo* [CARDOZO SYMPOSIUM] (careful analysis of the drafting history of UCC § 9-318).

<sup>62</sup> See Claire A. Hill, *Is Secured Credit Efficient?*, 80 TEXAS L. REV. 1117, 1129-1131, 1141-42 (2002) (discussing the importance of securitization particularly for large firms).

<sup>63</sup> 6 DELAWARE CODE § 2702A.

<sup>64</sup> ALA. CODE 1975 § 35-10A-2.

<sup>65</sup> N.C. GEN. STAT. § 25-9A-102.

<sup>66</sup> The Ohio statute, limited to failures of federally insured depository institutions, § OHIO REV. CODE ANN. 1109.75(C), provides: “Any property, assets, or rights purported to be transferred, in whole or in part, in a securitization shall be deemed to no longer be the property, assets, or rights of the transferor.” § 1109.75(A)(1). With considerable pluck, the statute goes on to provide: “In the event of the transferor’s bankruptcy, receivership, or other insolvency proceedings, the property, assets, or rights purported to have been transferred by the transferor, in whole or in part, in a securitization shall not be deemed to be part of the transferor’s property, assets, rights, or estate.” § 1109.75(A)(3).

<sup>67</sup> Texas has a non-uniform version of revised UCC § 9-109, which provides:

The application of this chapter to the sale of accounts, chattel paper, payment intangibles, or promissory notes is not to recharacterize that sale as a transaction to secure indebtedness but to protect purchasers of those assets by providing a notice filing system. For all purposes, in the absence of fraud or intentional misrepresentation, the parties’ characterization of a transaction as a sale of such assets shall be conclusive that the transaction is a sale and is not a secured transaction and that title, legal and equitable, has passed to the party characterized as the purchaser of those assets regardless of whether the secured party has any recourse against the debtor, whether the debtor is entitled to any surplus, or any other term of the parties’ agreement.

TEX. BUS. & COMM. CODE § 9-109(e).

The ultimate effect of those statutes is striking. Even if the attributes of the transaction – such as the credit risk retained by the originator – are such that the asset would be considered *not* to have been sold under traditional commercial-law principles,<sup>69</sup> the transaction is automatically treated as a true sale, removing the assets from any subsequent bankruptcy of the originator. To put it another way, those statutes allow the parties to have their transaction treated as a sale for bankruptcy purposes without obligating the purchaser to take on the risks that would be inherent in a complete transfer of the assets from the purported seller. Again, because the principal purpose of those statutes is to affect bankruptcy outcomes, they afford a prime example of bankruptcy-directed legislation.

#### IV. RESPONDING TO THE PROBLEM

The fact that states have chosen to enact legislation that affects the outcomes of federal bankruptcy proceedings is not, standing alone, adequate reason to invalidate those statutes. There are obvious reasons to leave the states with the broad authority to resolve commercial issues that Congress traditionally has given them. Most obviously, leaving the States broad room to resolve questions of commercial law furthers the interest in having equality of outcomes in the pre-bankruptcy and bankruptcy venues.<sup>70</sup> Thus, when a State adopts a statute that has substantial application before and during bankruptcy proceedings, it is difficult to view the State as having transgressed the limits on its authority. The application of such a statute in bankruptcy is uncontroversial because it is the commonplace working out of Congress's intent to incorporate background state commercial-law rules into the Bankruptcy Code.

Whatever the reader might think about the value of working for uniformity between pre-bankruptcy and bankruptcy outcomes,<sup>71</sup> it seems clear that State reliance on such a principle cannot have a decisive role in this context. For one thing, by hypothesis, the statutes that raise a substantial concern are those that have no significant effect outside bankruptcy. Thus, it is not a question of giving place to state rules to ensure evenhanded application of rules in parallel state and federal forums. It is much more – as my former colleague Jim White puts it – an effort by state legislators to affect something beyond their reach: “[L]imiting a trustee's rights by state law enactment is like trying to control an obstinate robot from a remote location; sometimes the directions get through and sometimes they do not.”<sup>72</sup> Particularly important on this point is the lack of symmetry discussed above: if the state is acting to benefit localized in-state interests at the expense of out-of-state (or broadly dispersed) interests, then the conditions that justify

---

<sup>68</sup> LA. REV. STAT. 10:9-109(e).

<sup>69</sup> For a lucid discussion of what those principles typically include, see Edwin E. Smith, *Proposal for a Uniform State Law on What Constitutes a True Sale of a Right to Payment* (Sept. 26, 2002) (unpublished manuscript on file with author).

<sup>70</sup> See, e.g., Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 578 (1998) (discussing reasons why bankruptcy outcomes should match pre-bankruptcy outcomes); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 824-28 (1987) (same).

<sup>71</sup> See, e.g., Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987) (discussing reasons why bankruptcy is inherently different from non-bankruptcy venues).

<sup>72</sup> White, *supra* note 61 (draft at 9).

federal deference to the State's determination are absent.<sup>73</sup> As discussed below, that seems to be true at least in the securitization examples.

What remains is to consider exactly what aspects of bankruptcy-directed legislation are sufficiently offensive to the federal system to justify invalidation. As I mentioned in the introduction, that is not so much a question of commercial policy as it is a question of the allocation of institutional authority. More specifically, it is a question of preemption: whether federal bankruptcy law preempts all or any of the legislation discussed in Part III.<sup>74</sup>

The Supreme Court, of course, has articulated a complicated (and not entirely consistent) body of doctrine governing the question of statutory preemption. Generally, federal statutes preempt state law in five related and overlapping circumstances: if Congress says so in express terms; if the federal scheme is so comprehensive as to support the inference that Congress intended to occupy the field; if the federal interest is so dominant that related state laws cannot be tolerated; if the federal and state statutes actually conflict (so that compliance with both is impossible); or if state law amounts to an obstacle to the purposes and objectives of the federal statute.<sup>75</sup>

As a theoretical matter, application of that framework to the bankruptcy context presents an odd and interesting situation. On the one hand, Congress has enacted a complicated, pervasive, and exclusive scheme of regulation – the Bankruptcy Code – which implements specific and detailed resolutions of a wide variety of policy questions raised in the context of the general default of an individual or business. At the same time, Congress specifically has determined that numerous aspects of that scheme should be defined by incorporation of rules that the States adopt from time to time. Thus, although the strength of the federal interest, and the Constitutional mandate that it be implemented in a uniform manner, would support a broad preemptive effect, the manner in which Congress has implemented the mandate counsels in just the opposite direction.

That tension would be a more difficult problem if the Court's cases made any effort to produce consistency of preemption doctrine across different subject-matter areas. But in reality, because that type of consistency is rarely achieved by the Court, it is no surprise that the Court's prominent cases dealing with state property rights (specifically, *BFP* and *Butner*) do not mention those tests, much less situate their analysis within the conventional framework of preemption analysis. Rather, those cases tend to articulate two related points. First, as discussed above, they occasionally have emphasized the Court's sense that Congress generally has chosen to defer to the states on questions of general commercial law.<sup>76</sup> Second,

---

<sup>73</sup> The point here is that in much of the commercial-law area the historical deference to state-law rules makes sense only to the extent that the rules are uniform. Where the states are competing to adopt non-uniform rules that favor a particular interest group, the system works poorly. Notice that the problem is much more difficult here than in the corporate context, where uniformity from state to state seems much less important.

<sup>74</sup> As I mentioned above, preemption in this context must come from the Bankruptcy Code, not the Bankruptcy Clause. *See supra* note 7.

<sup>75</sup> *E.g.*, *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992); *Hillsborough City v. Automated Medical Labs., Inc.*, 471 U.S. 707, 712-13 (1985); *Fidelity Federal Savings & Loan Ass'n v. De La Cuesta*, 458 U.S. 141, 152-53 (1982).

<sup>76</sup> *See supra* pp. 3-3.

*BFP* in particular reflects a deeply conservative<sup>77</sup> skepticism about claims that ambiguous provisions of the Bankruptcy Code of 1978 should be read to overturn long-settled practices of any kind.<sup>78</sup> That sentiment is not limited to *BFP* but rather features in a prominent line of other cases over the last twenty years.<sup>79</sup>

Read fairly, those cases do not suggest that the Court is any more disposed to find a presumption against preemption<sup>80</sup> in bankruptcy cases than they are in any other area.<sup>81</sup> More plausibly, they reflect a self-effacing unwillingness to rely on anything other than the clearest provisions of the Bankruptcy Code to support bold moves to preempt transparently legitimate (although possibly ill-conceived) exercises of state legislative policy. I say that the rules in question were “transparently legitimate” in the sense that there is no plausible basis for suggesting that they were adopted for the purpose of altering bankruptcy outcomes. The problem in *Butner* was whether federal law should reject or accept the long-standing distinction between the “lien” and “title” theories or mortgages.<sup>82</sup> In *BFP*, the question was whether the Bankruptcy Code was

---

<sup>77</sup> Here, I mean conservative in the status-quo sense rather than the political sense – the cases do not seem to me necessarily to favor creditors over debtors. For discussion of that understanding of conservatism, see Ernest Young, *Rediscovering Conservatism: Burkean Political Theory and Constitutional Interpretation*, 72 N.C. L. REV. 619 (1994).

<sup>78</sup> 511 U.S. at 540-543 (discussing historical roots of fraudulent-conveyance law and emphasizing that “[f]raudulent transfer law and foreclosure law enjoyed over 400 years of peaceful coexistence in Anglo-American jurisprudence until the Fifth Circuit’s decision [that the Court rejected in *BFP*]). It is interesting to note that this line of thought does not appear at all in *Butner*. The most obvious explanation is that *Butner* arose under the Bankruptcy Act of 1898, and that this concern did not come to the forefront until the Court began to face a barrage of claims arising out of the much more comprehensive Bankruptcy Code of 1978.

<sup>79</sup> The earliest cases articulating this principle under the Code were two opinions written by Justice Powell shortly before his 1987 retirement. *Kelly v. Robinson*, 479 U.S. 36, 44-47 (1986) (per Powell, J.); *Midlantic Nat’l Bank v. New Jersey Dep’t of Env’tl. Protection*, 474 U.S. 494, 501 (1986) (per Powell, J.). He rested the doctrine on two old (and theretofore little-noted) cases under the Bankruptcy Act of 1898 – *Swarts v. Hammer*, 194 U.S. 441, 444 (1904), and *Palmer v. Massachusetts*, 308 U.S. 79, 85 (1939). The doctrine has been repeatedly – some would say woodenly – applied in the intervening decades. *See, e.g., U.S. v. Noland*, 517 U.S. 535, 539 (1996); *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992); *see also U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 245-49 (1989) (detailed treatment of the doctrine to justify conclusion that pre-Code practice in *Ron Pair* was *not* dispositive).

<sup>80</sup> The existence of a general presumption to that effect is oft stated by the Court, but not followed with any discernible consistency. For a strong argument in favor of the presumption, see Ernest A. Young, “*The Ordinary Diet of the Law*”: *Federal Preemption and State Autonomy* (unpublished manuscript on file with author). *But see* Caleb Nelson, *Preemption*, 86 VA. L. REV. 225 (2000) (criticizing the presumption against preemption).

<sup>81</sup> *But see* Schwarcz, *supra* note 56 (3/10/03 draft at 7 n.36) (suggesting such a presumption). The Third Circuit, for example, has come close to articulating such a presumption in its decisions in *Integrated Solutions, Inc. v. Service Support Specialties, Inc.*, 124 F.3d 487, 491-92 (3<sup>rd</sup> Cir. 1997) (articulating a “restrained approach to concluding that Congress has intended to preempt state law in the bankruptcy context,” and noting that its approach “outside the bankruptcy context is similarly restrained when considering areas that have traditionally been governed by state law”); and *In re Roach*, 824 F.2d 1370, 1373-74 (3<sup>rd</sup> Cir. 1987) (holding that the right to cure a default on a mortgage ends at the moment of a judgment of foreclosure; subsequently overruled by the enactment of Bankruptcy Code § 1322(c)(1)). Although the *Roach* opinion does mention the Court’s general preemption analysis, it makes no serious effort to reconcile that line of reasoning with its reliance on *Butner*.

<sup>82</sup> 440 U.S. at 52-53; *see* Restatement (3<sup>rd</sup>) of Property: Mortgages § 4.1 comment a [hereinafter Restatement of Mortgages (discussing those theories)].

intended to overturn foreclosure sales conducted under conventional (albeit problematic) procedures for such sales.<sup>83</sup> In neither case could it have been suggested that the state-law rules were adopted with an eye to bankruptcy outcomes. If the states were to be criticized for anything in those cases, it was for failing to update their real-estate lending systems to accommodate the realities of modern commerce.<sup>84</sup> Indeed, one reading of those cases is that their strong emphasis on the status quo indicates that the Court would look critically at State efforts to alter “traditional” bankruptcy outcomes.

To be sure, the Court in *Butner* strongly emphasizes the need to maintain equality of outcomes between bankruptcy and nonbankruptcy venues for traditional issues of state property law – the circumstances under which a lender can obtain rents from real-estate collateral without foreclosing on the property.<sup>85</sup> But that is a thin reed to support validation of the kinds of bankruptcy-directed legislation discussed in Part III. The only significant bankruptcy policy at issue in *Butner* was the interest in uniformity – an interest that cuts in both directions given the value of uniformity of rules for real estate in a particular jurisdiction. Thus, under traditional preemption analysis it would be difficult to criticize the result in *Butner*.<sup>86</sup>

More broadly, the Court’s cases directly dealing with preemption in the bankruptcy context reflect an aggressive willingness to discipline state overreaching that undermines any effort to found a narrow bankruptcy-preemption regime on *BFP* and *Butner*. To be sure, the Court from time to time repeats the statement that the Bankruptcy Code preempts state law only in the event of an actual conflict.<sup>87</sup> But on other occasions the actual results of the cases that the Court has decided demonstrate a deeply seated willingness to find preemption even when it must rely on the vague possibility that state law operates as an “obstacle” to the “purposes and objectives” of federal bankruptcy law. This is particularly true in the cases decided shortly after the Bankruptcy Act of 1898, when Congress for the first time adopted a permanent bankruptcy scheme and thus produced a practical need to exclude the States from the field.

The leading case is *Perez v. Campbell*.<sup>88</sup> In *Perez*, the Court invalidated an Arizona statute that suspended a driver’s license for failure to pay a judgment discharged in a federal bankruptcy proceeding. The Court pointedly did *not* hold that the statute directly conflicted with the discharge in bankruptcy. Rather, it emphasized that “[i]n the final analysis, our function is to determine whether a challenged state

---

<sup>83</sup> 511 U.S. at 540-43.

<sup>84</sup> See, e.g., Restatement of Mortgages, *supra*, §§ 4.1 (adopting the lien theory of mortgages), 4.2 (adopting a coherent rule for perfecting a lender’s interest in rents before foreclosure).

<sup>85</sup> 440 U.S. at 54-57.

<sup>86</sup> The question is hypothetical in a sense, because *Butner* was not technically a preemption case, but whether a case about the power of a federal bankruptcy judge to rely on “equity” as a basis for recognizing a property interest that the state itself would not recognize. The distinction seems to me unimportant given the close relation between preemption doctrine and statutory interpretation. The ultimate question is whether the state rule will – or will not – apply in the bankruptcy proceeding.

<sup>87</sup> E.g., *Butner v. United States*, 440 U.S. 48, 54 n.9 (1979) (“[S]tate laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress.”); *Stellwagen v. Clum*, 245 U.S. 605, 613 (1918) (same).

<sup>88</sup> 402 U.S. 637 (1971).

statute ‘stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’”<sup>89</sup> The adoption of that test was not boilerplate; the Court overruled two previous decisions<sup>90</sup> that had upheld similar statutes, asserting that those cases had “ignored this controlling principle”<sup>91</sup> and thus created “aberrational doctrine.”<sup>92</sup> Indeed, of particular relevance for present purposes, the Court went on to emphasize that its decision was uninfluenced by evidence suggesting that such State statutes might have been adopted for some purpose other than frustration of federal bankruptcy policy:

We can no longer adhere to the aberrational doctrine \* \* \* that state law may frustrate the operation of federal law as long as the state legislature in passing its law had some purpose in mind other than one of frustration. Apart from the fact that it is at odds with the approach taken in nearly all our Supremacy Clause cases, such a doctrine would enable state legislatures to nullify nearly all unwanted federal legislation by simply publishing a legislative committee report articulating some state interest or policy – other than frustration of the federal objective – that would be tangentially furthered by the proposed state law.<sup>93</sup>

The Court reacted with similar vigor to state overreaching in *International Shoe v. Pinkus*.<sup>94</sup> In that case, Arkansas adopted a statute authorizing an insolvent individual to file suit seeking the appointment of a receiver to take and distribute the assets of the insolvent individual.<sup>95</sup> Under the statute, the receiver would liquidate the assets and distribute them to all claimants that agreed to accept a distribution as full satisfaction of their claims against the insolvent.<sup>96</sup> The case arose when an individual that was not eligible for federal bankruptcy relief (because of a discharge in bankruptcy less than six years earlier) sought relief under the Arkansas statute.<sup>97</sup> A judgment creditor sought to recover from the receiver without complying with the Arkansas statute.<sup>98</sup>

The Court started its analysis by emphatically adopting what we would now call an implied preemption doctrine:

---

<sup>89</sup> 402 U.S. at 649 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

<sup>90</sup> 402 U.S. at 650-52 (overruling *Kesler v. Department of Public Safety*, 369 U.S. 153 (1962); and *Reitz v. Mealey*, 314 U.S. 33 (1941)).

<sup>91</sup> 402 U.S. at 650.

<sup>92</sup> 402 U.S. at 652.

<sup>93</sup> 402 U.S. at 651-52. For an interesting lower-court application of that analysis, see *In re Baker & Drake, Inc. (Baker & Drake, Inc. v. Public Serv. Comm’n)*, 35 F.3d 1348 (9<sup>th</sup> Cir. 1994). That case considered a state statute requiring licensed cab drivers, which in the court’s view “was promulgated in part as a safety measure, and its substantive provisions do not facially belie that goal.” 35 F.3d at 1354. The court held the statute valid, even though it made reorganizations more difficult, explaining: “Congress’s purpose in enacting the Bankruptcy Code was not to mandate that *every company* be reorganized *at all costs*, but rather to establish a preference for reorganizations where they are legally feasible and economically practical.” 35 F.3d at 1354.

<sup>94</sup> 278 U.S. 261 (1929).

<sup>95</sup> 402 U.S. at 262-63.

<sup>96</sup> 402 U.S. at 263.

<sup>97</sup> 402 U.S. at 264-65.

<sup>98</sup> 402 U.S. at 263.

[T]he purpose to exclude state action for the discharge of insolvent debtors may be manifested without specific declaration to that end; that which is clearly implied is of equal force as that which is expressed. The general rule is that an intention to wholly exclude state action will not be implied unless, when fairly interpreted, an act of Congress is plainly in conflict with state regulation of the same subject. In respect of bankruptcies the intention of Congress is plain. \* \* \* States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.<sup>99</sup>

Read through the lens of cases like *Perez* and *Pinkus*, it is easy to conclude that bankruptcy-directed legislation often would be preempted. To be sure, there is no basis for a claim of express preemption or that Congress has occupied the field: the discussion above makes it clear that there is an important role for state law in the bankruptcy process. But Congress's decision to build the bankruptcy system for the most part on preexisting rules of state property law cannot plausibly be interpreted as giving the states blanket authority to legislate in support of whatever bankruptcy outcomes seem desirable to them. Rather, as *Perez* teaches, a state statute that has a substantial effect *only* in bankruptcy is preempted whether or not it directly conflicts with some specific provision of the Bankruptcy Code.<sup>100</sup> Such a rule at once accommodates Congress's intent to incorporate background commercial-law rules into bankruptcy practice and at the same time provides a limit beyond which states cannot go in attempting to alter bankruptcy outcomes. It rests on the same intuition as Bankruptcy Code Sections 544 and 545 – that the States should not be able to affect bankruptcy outcomes unless they are willing to apply the rules to a substantial amount of pre-bankruptcy conduct.

To start with the easiest example, the pro-securitization statutes reflect an obvious attempt to alter the content of the property of the estate under Bankruptcy Code § 541. Absent those statutes, bankruptcy courts would apply traditional principles to determine whether a seller's obligations and risks with respect to securitized assets remained sufficiently substantial to make those assets "property" of the bankrupt. Only in the most hypothetical of transactions would those statutes have any application outside of bankruptcy – indeed, several of them display their intended substantive range by making specific references to the intended bankruptcy effect.<sup>101</sup> The point of those statutes is to cause bankruptcy courts to ignore those principles. Hence, a bankruptcy court should ignore the label any such state law might place on such a

---

<sup>99</sup> 402 U.S. at 265 (citations omitted); *see also* *Bessette v. Avco Fin. Servs., Inc.*, 230 F.3d 439, 447-48 (1<sup>st</sup> Cir. 2000) (relying on that statement in *Pinkus* to invalidate a state-law remedy for violation of a reaffirmation agreement). For dictum (in a case rejecting preemption) to a similar effect *see* *Stellwagen v. Clum*, 245 U.S. 605, 615 (1918) (stating that a conflict with federal law would be intolerable if a "state statute is \* \* \* opposed to the policy of the bankruptcy law or in contravention of the rules and principles established by it with a view to the fair distribution of the assets of the insolvent"); *see also id.* (commenting that state laws "in aid of the Bankruptcy Act can stand" and approving lower court analysis that validated state statutes as "in harmony with the policy of the Bankruptcy Act and in aid of its purposes").

<sup>100</sup> *But see* *Nelson*, *supra* note 80, at 265-90 (arguing that the Court should discard its "obstacle" preemption doctrine).

<sup>101</sup> *See supra* notes 66-67.

transaction.<sup>102</sup> And if the transaction is not a sale under conventional principles, that means that the assets that the transaction purported to sell remain in the estate of the bankrupt originator.<sup>103</sup>

Of course, it might cause considerable uncertainty for securitization transactions if they were at risk in each case of a post-hoc determination that the terms of the “sale” on which they rested were not adequate.<sup>104</sup> In practice, however, I am not sure that is a major problem – it may be that sophisticated lawyers in this practice know when they have structured transactions that clearly conform to the customary principles and know when they have come “close to the line.”<sup>105</sup> On the other hand, if that is a serious problem, it would be easy enough to draft a statute setting out legislative safe harbors.<sup>106</sup> Moreover, if those safe harbors reflected customary principles of a sale, the framework discussed here suggests that bankruptcy courts should respect that statute even if it were adopted as a matter of state (rather than federal) law.

The second example is UCC § 9-408. That provision is categorically less objectionable than the securitization statutes, because it does not reflect the kind of corrosive interstate competition that is the fundamental basis for national power over bankruptcy.<sup>107</sup> That circumstance does not seem to me, however, enough to save the provision. Again, the question is not whether it would be a good thing for creditors to have access to security interests in nonassignable intangible assets.<sup>108</sup> Rather, the question is whether the statute resolves that question in a way that is properly within the purview of the Article 9 Drafting Committee. The Committee’s decision to resort to the odd device of a security interest that has no effect of

---

<sup>102</sup> For analogous analysis, see *United States v. Craft*, 535 U.S. 274 (2002) (holding that state label of husband’s rights as a tenant by the entirety was not dispositive of the question whether a federal tax lien could attach to the husband’s interest in property).

<sup>103</sup> As I understood them, Thomas Plank’s comments at the Conference suggest the view that such a rule would exceed Congress’s authority under the Bankruptcy Clause. I disagree. Using Plank’s own understanding of that Clause, I think it is well within Congress’s authority to define “property of the estate” to include assets over which the originator retains such a significant degree of responsibility. See Thomas E. Plank, *Bankruptcy and Federalism*, 71 *FORDHAM L. REV.* 1063, 1096-1100 (2002) (discussing Congress’s power to define property of the estate).

<sup>104</sup> See Schwarcz, *supra* note 56 (3/10/03 draft at 5) (characterizing the risk of judicial recharacterization as “the strongest threat to securitization”).

<sup>105</sup> My views on that point are strongly influenced by listening to the conversations of experienced lawyers on that point in recent meetings of a committee on capital markets formed by the National Bankruptcy Conference.

<sup>106</sup> See Smith, *supra* note 69 (proposing such a statute).

<sup>107</sup> See Cole, *supra* note 22, at 238-39. A statute designed for uniform nationwide adoption cannot be the source of a race to the bottom.

<sup>108</sup> I am personally inclined to think that the problem is not an important one, given the availability of alternative transactional structures that lessen the importance of such an interest. See Mann, *supra* note 44, at 167-79. I recognize, however, that the provision was thought to be of great importance by representatives of a variety of affected industries that participated directly in the drafting of Article 9. For a good summary of the potential benefits from the provision, see Thomas E. Plank, *The Limited Security Interest in Non-Assignable Collateral Under Revised Article 9*, 9 *ABI L. REV.* 323, 329-39 (2001). For a critical assessment, see Lorin Brennan, *Financing Intellectual Property Under Revised Article 9: National and International Conflicts*, 23 *HASTINGS COMM./ENT. L.J.* 313, 397-413 (2001).

any substance *except* during a bankruptcy proceeding<sup>109</sup> persuades me that this is *not* a proper exercise of state legislative power.<sup>110</sup> Thus, I do not think a federal bankruptcy court should respect an interest validated only by that section as a “security interest” under Bankruptcy Code § 101(51).<sup>111</sup> In any event, the great lengths to which the Committee was forced to go make a statutory resolution of this particular case even easier: it seems almost obvious that this is the rare example of a state statute that should fall before the literal filter of Bankruptcy Code § 545, as a lien that is not “effective” and “enforceable” before a bankruptcy filing.

The hardest example is the expanded provisions related to proceeds. Those present a much closer question, because – unlike the two previous examples – they do not reflect the direct enactment of a rule that has effect only in bankruptcy. The broadened rule of proceeds has considerable impact in a variety of contexts purely within Article 9.<sup>112</sup> Moreover, Bankruptcy Code § 552 is quite explicit in its adoption of state-law principles as the foundation for its operation.<sup>113</sup> Thus, the analysis of this article suggests that the provision should not be condemned as bankruptcy-directed legislation.

Still – and here the distinction between preemption analysis and statutory interpretation is admittedly a fine one<sup>114</sup> – I think a strong case can be made that the expanded definition of proceeds should not alter the reach of Section 552. The ability – or inability – of a debtor’s estate to acquire unencumbered assets during the course of a bankruptcy directly affects concerns at the core of bankruptcy proceedings, especially

---

<sup>109</sup> See Warner, *supra* note 54, at 51 (“[T]he secured party’s rights [under § 9-408] outside of bankruptcy are virtually non-existent.”), 54 (characterizing § 9-408 as “bankruptcy-targeted insolvency value reallocation rules masquerading as neutral principles of state commercial law”).

<sup>110</sup> This is quite different, for example, from the use of a statutory lien to appease a local special-interest group. It may be that the state legislature adopting such a statute would be engaged in the kind of corrosive interstate competition that is objectionable in our federal system. But if the legislature is willing to give the lien priority and enforceability before bankruptcy – as legislatures typically do – then the statute is not objectionable under the analysis that I propose here. To be sure, Congress might choose to overturn the policy within the Bankruptcy Code. I only suggest here that such a statute is not “implicitly” preempted by the existing Code. It is not bankruptcy-directed legislation for a state to make a bad policy choice that applies both within and outside bankruptcy. The proper framework for analyzing such a statute is the Commerce Clause, which provides adequate protection for out-of-state businesses concerned about such legislation. *Compare, e.g.,* Edgar v. MITE Corp., 457 U.S. 624 (1982) (invalidating state takeover regulation), *with* CTS v. Dynamics Corp., 481 U.S. 69 (1987) (upholding control-share acquisition statute against such a claim).

<sup>111</sup> Thomas Plank argues that the interest should be valid in bankruptcy, Plank, *supra* note 108, at 341-44, but he does not address my concern – that the statute has created an interest of primarily bankruptcy-related importance by systematically carving away all substantial pre-bankruptcy effects that the interest might have.

<sup>112</sup> Among other things, they result in valuable security interests in collateral that is in the hands of parties other than the debtor, security interests that presumably could be enforced under Article 9 without regard to any bankruptcy proceeding involving the original debtor. See Lipson, *supra* note 47, at 1373-74.

<sup>113</sup> That section provides: “[The] security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by \* \* \* applicable nonbankruptcy law.”

<sup>114</sup> See Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767, 807-12 (1994) (arguing that preemption should *never* be treated as distinct from ordinary statutory interpretation).

business reorganizations under Chapter 11. Because Congress wrote Section 552 against the background of the then-existing Article 9, the concerns about maintaining the status quo that have animated the Court's bankruptcy jurisprudence in cases such as *Butner* and *BFP* would support an interpretation of the reference to "proceeds" that did *not* change with the meaning of that term in state law. To put the point more directly, it is fair to believe that the drafters of Section 552 did not intend that Section's balance between encumbered and unencumbered assets to be subject to unilateral post-hoc expansion by the ALI and NCCUSL through the UCC process.<sup>115</sup> Such a narrow view of the reference to "proceeds" seems particularly plausible given the express statutory authorization to courts to limit the 552(b)(1) interest "to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise." It is reasonable to think that in making such a determination the court could endeavor to preserve the balance that existed under the legal framework in existence at the time Congress enacted the statute.

## V. CONCLUSION

The ineluctable pressures of free trade and globalization are making the American business environment ever more competitive.<sup>116</sup> That ensures, in turn, that state legislatures will more frequently in the years to come be pressed to take sides in contentious issues about commercial finance. The time will come when federal bankruptcy courts must draw the line somewhere in their deference to those enactments. I hope this paper provides a first step toward understanding how and where that line should be drawn.

---

<sup>115</sup> Again, the best example of such a perspective is *United States v. Craft*, 535 U.S. 274 (2002).

<sup>116</sup> See, e.g., THOMAS L. FRIEDMAN, *THE LEXUS AND THE OLIVE TREE: UNDERSTANDING GLOBALIZATION* (1999).